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T.R.A. DOCKET ROOM

February 13, 2004

Honorable Deborah Taylor Tate
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37243-0505

Re Re Complaint of US LEC of Tennessee Inc Against Electric Power
Board of Chattanooga
Docket No 02-00562

Dear Chairman Tate

Attached are the original and fourteen copies of Rebuttal Testimony of Dr Christopher C Klein and Jason McVay on behalf of US LEC of Tennessee, Inc in the above-captioned proceeding

Very truly yours,

BOULT, CUMMINGS, CONNERS & BERRY, PLC

By



Henry Walker

HW/pp

**BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE**

February 13, 2004

**COMPLAINT OF US LEC OF TENNESSEE, INC. AGAINST ELECTRIC POWER
BOARD OF CHATTANOOGA**

DOCKET NO. 02-00562

**REBUTTAL TESTIMONY OF
DR. CHRISTOPHER C. KLEIN
ON BEHALF OF US LEC OF TENNESSEE, INC.**

1 **Q Please state your name and your current position.**

2 A My name is Christopher C Klein and I am an Associate Professor in the Economics and
3 Finance Department at Middle Tennessee State University (MTSU) in Murfreesboro,
4 Tennessee

5 **Q What is your educational background?**

6 A I received a B A in Economics from the University of Alabama in 1976 and I received a
7 Ph D in Economics from the University of North Carolina at Chapel Hill in 1980

8 **Q What is your professional experience involving regulated industries?**

9 A I was employed as an Economist in the Antitrust Division of the Bureau of Economics at
10 the Federal Trade Commission (FTC) in Washington, D C , for six years starting in 1980
11 In 1986, I was hired as the first Economist for the Tennessee Public Service Commission
12 (TPSC) Although my title changed over the years, I functioned as the Chief Economist
13 for the TPSC and, after 1996, the Tennessee Regulatory Authority (TRA), until August of
14 2002, when I assumed my current position with MTSU

15 **Q What were your duties at the FTC?**

1 A I performed the economic analysis in antitrust investigations involving more than 20
2 industries and contributed to staff reports on mergers in the petroleum industry,
3 competition in grocery retailing, and the economics of predatory or sham litigation

4 Q **What was your primary responsibility at the TPSC?**

5 A I was an expert witness for the staff of the TPSC in rate cases and other similar
6 proceedings involving telecommunications, natural gas, electric and water utilities and
7 motor carriers I testified in 36 dockets before the TPSC on the issues of cost of capital,
8 rate design, and competitive effects I also filed testimony before the Federal
9 Communications Commission (FCC)

10 Q **How did your responsibilities change when the TRA supplanted the TPSC?**

11 A I oversaw the Utility Rate Division and then the Economic Analysis Division The TRA
12 staff no longer testified in proceedings before the agency, but provided analysis and
13 advice to the TRA Directors I was responsible for all such advice and analysis provided
14 to the Directors by these Divisions, either individually or in concert with other TRA staff,
15 in all proceedings that came before the agency for resolution These proceedings
16 included rate cases and tariff filings by public utilities, as well as those associated with
17 the implementation of the federal Telecommunications Act of 1996

18 Q **Were you a member of any regulatory committees or boards while you worked for
19 the TPSC and the TRA?**

20 A Yes I was a member of the National Association of Regulatory Utility Commissioners
21 (NARUC) Staff Subcommittee on Gas I was a member of, and Chaired, the Research
22 Advisory Committee to the Board of Directors of the National Regulatory Research
23 Institute (NRRI) I also served on the State Staff of the FCC's Federal-State Joint Board

1 in CC Docket No 80-286 (the "Separations" Joint Board) and as a Group Leader on the
2 NARUC Staff Subcommittee on Accounts Multi-state Audit Team that produced the
3 1988 Report on Bell Communications Research

4 Q **What is your primary responsibility at MTSU?**

5 A I teach classes in the general area of applied microeconomics, including Managerial
6 Economics and Principles of Microeconomics, as well as undertaking scholarly research
7 and participating in various university committees

8 Q **Have you taught at any other universities?**

9 A I taught classes in the Economics of Regulation and in Antitrust Economics in the
10 Economics Department at Vanderbilt University on an adjunct basis for several years

11 Q **Are you a member of any professional organizations?**

12 A I am a member of the American Economic Association and its Transportation and Public
13 Utilities Group, the Southern Economic Association, the Western Economic Association,
14 the Industrial Organization Society, and Alpha Pi Mu, the National Industrial
15 Engineering Honor Society

16 Q **Have you published articles in professional or academic journals and presented
17 papers at professional meetings?**

18 A More than 30 of my articles have appeared in professional or academic journals and I
19 have made more than 50 presentations at professional meetings

20 PURPOSE OF TESTIMONY

21 Q **What is the purpose of your testimony?**

22 A I will respond to the testimony of Mr Harold DePriest (Prefiled Rebuttal Testimony and
23 Exhibits of Harold E DePriest) in which he claims that the Chattanooga Electric Power

1 Board (EPB) is not providing a cross-subsidy to EPB Telecom by allowing them the free
2 use of EPB's brand, including EPB's reputation and goodwill In doing so, I address
3 three primary questions 1) the value of EPB's brand, 2) whether EPB Telecom's use of
4 the EPB brand constitutes a subsidy, and 3) the appropriate remedies for any such
5 subsidy that the Tennessee Regulatory Authority (TRA) should consider

6 THE VALUE OF THE EPB "BRAND"

7 Q **Does EPB's brand, reputation, and goodwill have value?**

8 A Yes From the standpoint of Economics, EPB's establishment of a quality reputation and
9 goodwill with its customers and the community has created an asset much like a brand
10 name This brand is an instantly recognizable means of associating EPB's reputation
11 with its products and services EPB's Mr DePriest states that the "EPB name and
12 customer-centered philosophy are integral parts of who we are" (Prefiled Rebuttal
13 Testimony of Harold E DePriest, p 2) There would be no reason to associate the EPB
14 Telecom operation with the EPB name and reputation, as the exhibits to Mr Moeller's
15 testimony illustrate, if the EPB brand had no value (Direct Testimony of Michael G
16 Moeller) Moreover, EPB would not be fighting US LEC's challenge to its use of the
17 EPB brand if it did not convey a competitive advantage in the marketplace

18 Further, Jason McVay, in his rebuttal testimony, confirms the value that EPB
19 placed on its brand as a means of selling the telecommunications service "I was told
20 repeatedly that the best way to persuade customers to buy from EPB Telecom was to
21 emphasize the relationship between EPB Telecom and EPB As a city-owned, monopoly
22 electric company that has been in business for decades, the name EPB is obviously well
23 known throughout the Chattanooga area We were told, 'People are going to buy from

1 EPB Telecom because of the EPB brand We are going to sell off the EPB brand '
2 Selling the brand was their principal marketing strategy ” (Rebuttal Testimony of Jason
3 McVay, p 2)

4 Q **Do EPB Telecom’s marketing expenditures indicate that the EPB brand has little**
5 **value?**

6 A No That EPB Telecom must expend resources to inform customers of its existence and
7 the nature of its services is not surprising Other new entrants providing
8 telecommunications services in Chattanooga, however, must expend similar resources to
9 inform customers **plus** additional sums, possibly in the form of lower prices or foregone
10 revenues, in order to build a favorable reputation in the marketplace To the extent EPB
11 Telecom avoids such reputation-building costs, it enjoys a competitive advantage over
12 other new entrants from its association with EPB

13 **SUBSIDY AND THE EPB BRAND**

14 Q **Does EPB Telecom’s use of the EPB brand constitute a subsidy?**

15 A Yes It is a subsidy because EPB Telecom has the use of a valuable EPB asset without
16 paying for it It is just as if EPB allowed EPB Telecom to use a portion of its existing
17 office space without paying rent

18 Q **What are the effects of such a subsidy?**

19 A Obviously, EPB Telecom has an advantage over other new entrants in attracting
20 customers by reference to EPB’s history of reliability, stability, and customer service
21 Less obvious is the harm to EPB’s electric ratepayers If EPB Telecom paid for the use
22 of the EPB brand, this would generate revenues for the electric operation that could be
23 used to reduce electric rates EPB Telecom’s failure to pay for the use of a valuable EPB

1 asset denies lower rates to EPB's electricity customers. Moreover, EPB's electric
2 ratepayers, perhaps unwittingly, subsidize EPB Telecom by allowing it to use the EPB
3 brand in competition with other new entrants.

4 **Q How is this any different from the use of an investor-owned electric company's**
5 **brand by its telecommunications operation?**

6 **A** First, the telecom operation may be paying a fee, or more likely a royalty, for the use of
7 the electric company brand. On the other hand, there may be no express payment for use
8 of the brand. In this case, the company's stockholders are at risk for any degradation or
9 enhancement of the value of the brand from its use by the telecom operation.

10 For example, if the telecom operation is not successful and goes out of business,
11 then not only do the stockholders lose the profits that a successful business would
12 generate, but the company's reputation for quality, reliability, and stability is diminished.
13 This diminished reputation undermines the company's ability to attract and retain
14 customers in its other current or future businesses, thereby reducing the profits from those
15 businesses as well. The reduction in expected profitability due to the degraded value of
16 the brand then causes the company's stock price to fall, in turn causing a reduction in
17 stockholders' wealth.

18 Of course, if the telecom operation is successful and the value of the brand is
19 enhanced, then the stock price may rise and stockholders benefit. The telecom
20 operation's competitive advantage from use of the brand translates into higher profits
21 which compensate the stockholders for the use of the brand.

22 In either case, the stockholders stand to reap the gain or suffer the loss from the
23 use of the brand and can incorporate their assessment of that risk into their decision to

1 hold or sell the stock. There is no subsidy, because the stockholders bear the risk of gain
2 or loss on the use of the brand. This, of course, cannot occur in the case of a municipal
3 corporation such as EPB.

4 **Q Who bears the risk associated with the use of EPB's brand?**

5 **A** The electric operation's ratepayers and/or, ultimately, taxpayers. This is one reason the
6 issue of cross-subsidy arises when publicly-owned operations, like municipal
7 corporations, provide goods or services in competition with investor-owned operations.
8 There are no stockholders to assess the risk and either accept it, or demand payment for
9 the use of the brand. Those who bear the risk indirectly – customers or taxpayers – may
10 not even be aware of it. Thus the danger arises that some items, especially implicit or
11 less tangible costs and benefits that do not directly generate a cash-flow, may go
12 unnoticed and, consequently, generate a cross-subsidy. That is exactly the case for EPB
13 Telecom's use of the EPB brand.

14 REMEDIES

15 **Q What can remedy this cross-subsidy?**

16 **A** There are two possibilities. One is the remedy that US LEC seeks: that EPB Telecom
17 cease associating itself with EPB in its marketing efforts. The other is for EPB Telecom
18 to pay EPB for the use of its brand.

19 **Q Are such payments for the use of a brand common among unregulated businesses?**

20 **A** Yes, these arrangements are quite common, most often in the context of franchising
21 arrangements. The most familiar industry in which this is seen is fast food restaurants,
22 but it is hardly exceptional.

23 **Q What form do these payments take and how are they determined?**

1 A Franchise payments generally consist of an upfront fixed payment followed by a royalty
2 stated as a percentage of sales. The use of a royalty rate allows the parties to share the
3 risk inherent in uncertainties over the value of the arrangement in any particular instance.
4 The amounts are ultimately determined by the franchisor's and franchisee's assessment
5 of the value of the arrangement – that is, by market factors. In some cases the franchisor
6 undertakes advertising and promotional activities on behalf of the franchisees and may
7 also impose certain operating restrictions or quality specifications on them.

8 Q **How large are these payments?**

9 A The fixed fees vary considerably, from \$5,000 to approaching \$100,000. The royalty
10 rates also vary, from 1% to as high as 12.5% of sales.

11 Q **What sort of fee is appropriate in this case?**

12 A Given uncertainty as to the exact value of the EPB brand, determining the amount of the
13 fee is somewhat speculative. This suggests that a royalty fee as a percentage of the sales
14 of the telecom operation may be most appropriate. Of course, the royalties and fees
15 should apply retroactively to the point EPB Telecom first realized revenues, as well as to
16 its revenues going forward.

17 Q **What is the other alternative remedy?**

18 A That EPB Telecom cease its use of the EPB brand in marketing its services.

19 Q **How could this be accomplished?**

20 A EPB Telecom could adopt a different "d/b/a" name for marketing and sales purposes.
21 "EPB Telecom" is, in fact, a d/b/a for the Telecommunications Division of EPB. EPB
22 Telecom then develops its own brand independent of EPB. Its marketing media and its
23 sales force would necessarily cease the use of, or references to, its relationship to EPB.

1 The change would not necessarily have to be abrupt. Some transition period may be
2 appropriate to allow EPB to inform its customers and the public of the change. After
3 that, the subsidy would be effectively eliminated.

4 Q **Which remedy do you recommend?**

5 A The “d/b/a”, as opposed to the royalty, is the cleaner alternative and easier to enforce.
6 The fee remedy suffers from uncertainty as to the value of the EPB brand and,
7 consequently, from uncertainty as to the amount of the appropriate fee. If the fee is set
8 too low, the subsidy continues, set too high, the payment disadvantages EPB Telecom
9 relative to other new entrants. Moreover, enforcement may require independent audits to
10 make sure the fees are paid. The “d/b/a” alternative suffers from no similar uncertainties
11 and may be enforced by observing relatively public marketing and sales activity.

12 Q **Mr. DePriest claims that changing the name of EPB Telecom could prevent EPB**
13 **personnel from using the name in reports or Board meetings which are open to the**
14 **public and reported in the news media. (Prefiled Rebuttal Testimony and Exhibits**
15 **of Harold E. DePriest, p. 22) Do you agree?**

16 A No. As “EPB Telecom” is itself a d/b/a, public references could refer accurately to the
17 Telecommunications Division of EPB, regardless of its d/b/a. Reports of the new d/b/a in
18 news media items about the Telecommunications Division are likely unavoidable, but as
19 long as these references were not used, or instigated, by EPB for marketing purposes, the
20 subsidy issue does not arise. If EPB uses “EPB Telecom” to refer to its
21 Telecommunications Divisions in these instances and uses another d/b/a for marketing
22 and sales of its services, then under the conditions outlined above, that should not

1 generate any significant subsidy The d/b/a and EPB are not directly associated for the
2 purpose of selling telecommunications services in either case

3 Q **Mr. DePriest also claims that implementing the d/b/a remedy would be “confusing**
4 **to our present customers, demoralizing to our sales force, and costly to our**
5 **operations.” Further, he states that this remedy, “would be administratively**
6 **unworkable; and it would be very confusing to the public.” (Prefiled Rebuttal**
7 **Testimony and Exhibits of Harold E. DePriest, pp. 21-23) Do you agree?**

8 A If Mr Depriest means that there will be costs imposed on EPB for implementing the
9 remedy, then I can agree on that basis I do not agree, however, with the suggestion that
10 the presence of such costs should deny US LEC any relief I understand that state law
11 makes subsidies from a municipal electric system to its telecommunications services
12 illegal The presence of costs associated with the remedy does not make the subsidy
13 legal

14 Mr DePriest also may imply that these costs are larger than they actually are
15 Certainly other CLECs have changed their corporate names or d/b/a's and survived the
16 costs and confusion this may have entailed One of the most familiar examples of this
17 followed the merger of Nextlink and Concentric, with the surviving entity changing its
18 name to XO Whatever the costs associated with such a change for EPB, it is difficult to
19 believe that they would be competitively fatal

20 One must also consider that EPB Telecom has received the benefit of association
21 with the EPB brand for several years These benefits will not be erased by the remedy
22 proposed here It is possible that the benefits EPB Telecom has already received as a
23 consequence of its illegal activity may outweigh the costs associated with the remedy

1 If the TRA is concerned about the magnitude of these costs, then the use of a
2 transition period for accomplishing the remedy may mitigate them. Obviously, EPB
3 must be allowed sufficient flexibility that it can efficiently inform its customers of the
4 changes that the remedy requires.

5 Q **Does this conclude your testimony at this time?**

6 A Yes

**BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE**

February 13, 2004

IN RE Complaint of US LEC of Tennessee Inc) Docket No 02-00562
Against Electric Power Board of Chattanooga)

REBUTTAL TESTIMONY OF JASON MCVAY

1 Q: PLEASE STATE YOUR NAME AND OCCUPATION.

2 A My name is Jason McVay and I work for US LEC of Tennessee Inc as an account
3 executive in the Chattanooga, Tennessee area I have been with US LEC since October,
4 2003

5 **Q: WHO WAS YOUR PREVIOUS EMPLOYER?**

6 A I worked as an account manager for EPB Telecom from January, 2002 until October,
7 2003

8 **Q: WHAT WERE YOUR RESPONSIBILITIES AT EPB TELECOM?**

9 A I was a sales person My job was to sell the services of EPB Telecom and, following a
10 sale, to manage those accounts

11 **Q: WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

12 A The purpose of my testimony is to rebut the testimony of Mr Harold DePriest concerning
13 the marketing strategy of EPB Telecom

14 **Q: SPECIFICALLY, WHAT PORTION OF MR. DEPRIEST'S TESTIMONY DO YOU**
15 **DISPUTE?**

16 A On page 21, lines 8-15, of his testimony, Mr DePriest denies that EPB Telecom tries to
17 differentiate itself from other competitive local carriers "solely from the basis of its
18 affiliation from EPB Electric " While it is true that the marketing of EPB Telecom

1 touched on a number of issues, the main thrust of all of our marketing efforts was to sell
2 the EPB brand

3 **Q: PLEASE EXPLAIN.**

4 A I was often given instructions about how to sell the services of EPB Telecom I was told
5 repeatedly that the best way to persuade customers to buy from EPB Telecom was to
6 emphasize the relationship between EPB Telecom and EPB Electric As a city-owned,
7 monopoly electric company that has been in business for decades, the name EPB is
8 obviously well known throughout the Chattanooga area We were told, "People are
9 going to buy from EPB Telecom because of the EPB brand We are going to sell off the
10 EPB brand " Selling the brand was their principal marketing strategy

11 **Q: WERE YOU EVER TOLD THAT YOU WERE SUPPOSED TO INFORM**
12 **CUSTOMERS THAT EPB AND EPB TELECOM WERE SEPARATE ENTITIES?**

13 A No Early on, I recall hearing some vague conversation about US LEC complaining
14 about the EPB Telecom name But after a while, it seemed there was a change and that's
15 when they really pushed the EPB brand We were never told that we had to tell
16 customers that the two entities are not the same To the contrary, we were told to
17 emphasize that EPB Telecom was part of EPB

18 **Q: MR. DEPRIEST ALSO SAID THAT ADOPTING A NEW "D/B/A" NAME FOR**
19 **THE TELECOMMUNICATIONS DIVISION WOULD BE 'DEMORALIZING TO**
20 **OUR SALES FORCE" (PP. 21-22). DO YOU AGREE?**

21 A Yes, I agree It would be a much more difficult sale without using the EPB name As I
22 testified earlier, the EPB name is well known in Chattanooga and that's one of the main
23 reasons people buy from EPB Telecom The sales teams will have to sell products and
24 services differently if they cannot take advantage of selling using the EPB brand

1 **Q: COULD EPB's TELECOMMUNICATIONS DIVISION STILL SELL SERVICE**
2 **WITHOUT THE EPB BRAND?**

3 A Yes They could do it by emphasizing those other points that Mr DePriest mentions in
4 his testimony they are locally owned and controlled, they have their own facilities, they
5 are active in the community, and they have local customer service representatives Those
6 are all valid points What they wouldn't have is the advantage of using the good will and
7 reputation of EPB, which was paid for by the electric ratepayers, in order to persuade
8 people to buy telephone service That's what gives EPB Telecom an advantage over
9 other carriers

10 **Q: DOES THAT CONCLUDE YOUR TESTIMONY?**

11 A Yes

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing has been forwarded via U S Mail, postage prepaid, to the following on this the 13th day of February, 2004

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